COMPANY RESEARCH AND ANALYSIS REPORT

NIHON CHOUZAI Co., Ltd.

3341

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FISCO Ltd. Analyst

Hiroyuki Asakawa

FISCO

FISCO Ltd.

http://www.fisco.co.jp

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Summary

Steady growth in all three business segments
It seems that the revisions to the Pharmaceutical and Medical Device Act have been a turning point, and the Company is steadily progressing "preparations" for this law

NIHON CHOUZAI Co., Ltd. <3341> (hereinafter, also "the Company") is a leading domestic dispensing pharmacy company that ranks second in sales in the dispensing pharmacy industry. The Nihon Chouzai Group manufactures generic pharmaceuticals, so one of its key characteristics is that it has a manufacturing function. It additionally has a staffing and placement business for medical professionals and an information-provision and consulting business, and it is developing its operations with a structure that covers four business departments.

1. In 1H FY3/20, sales and profits grew steadily in all 3 fields. The balance of profits also improved.

In the Company's 1H FY3/20 results, sales increased and profits increased significantly, with net sales of ¥130,297mn (up 9.8% year-on-year (YoY)) and operating profit of ¥4,066mn (up 162.8%). Sales and profits increased in all three business segments and moreover, operating profit exceeded the initial forecast, so the results were extremely strong. Furthermore, operating profit grew greatly in both the Pharmaceutical Manufacturing and Sales business and the Medical Professional Staffing and Placement business, which improved the balance of profits between the business segments and suggests that the Company is making steadily progress toward realizing the earnings structure it is aiming for in the medium- to long-term.

2. Toward medium- to long-term growth, is entering a period of fully fledged growth not only in the Dispensing Pharmacy business, but also in the Pharmaceutical Manufacturing and Sales business

The Company is working on a growth strategy based on the Long-Term Vision for 2030. In the Dispensing Pharmacy business, it seems that the 2019 revisions to the Pharmaceutical and Medical Device Act was a major turning point. In these revisions, the importance was placed on human resources, or more specifically, on improving the quality of pharmacists, and the Company is succeeding in creating a virtuous circle in which it provides high quality education, which is effective for employee motivation and leads to the improvement of medical services and earnings, which in turn improves the employee retention rate and enables it to further secure human resources. In the Pharmaceutical Manufacturing and Sales business, a cooperative model with the Dispensing Pharmacy business is functioning, and it is making steady progress for sales. In the previous fiscal period, the Company completed the investment in facilities required for the time being, while it has also been confirmed that the new plant is operating steadily. So going forward, for production it will enter a stage of pursuing a fully-fledged increase in earnings. One of the keys to this will be contracted production, and while the Company has been steadily acquiring contracts for this up to the present time, it is working toward further increasing the number of contracts, including for large-scale projects.

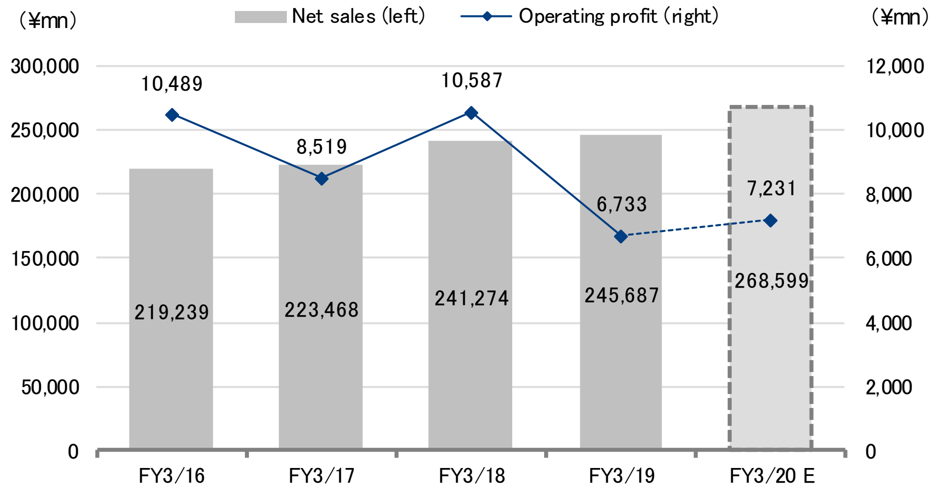
3. The outlook is for results to also trend strongly in 2H FY3/20. The focus will be on the innovations created by President and CEO Yosuke Mitsuhara.

For the FY3/20 full year outlook, the Company has left the initial forecasts unchanged. As it made steady progress up to 1H FY3/20, expectations have risen that not only will it achieve the full fiscal year forecasts, but that it will also upwardly revise the forecasts, as the standard for the timely disclosure of upward revisions would seem to have been surpassed. But on this point, the revisions to drug prices in October 2019 following the consumption tax hike will have an impact, so it would be wise to cautiously assess how results are trending. But no matter the case, there is little cause for concern about the results, and at FISCO, we think that the focus should instead be on the direction to take in the medium- to long-term, including the response to the revisions to dispensing fees that will take place in April 2020. The previously mentioned revised Pharmaceutical and Medical Device Act provides a major hint for the content of these revisions. But in addition to this, we shall also be focusing on what kinds of innovations will be created by the President and CEO Yosuke Mitsuhara, who was appointed in June 2019 and how he will accelerate the growth strategy.

Key Points

- No change to Company's stance based on the Long-Term Vision for 2030
- In the 2019 revisions to the Pharmaceutical and Medical Device Act, the importance of "human resources" was further increased, and the Company is steadily advancing preparations for this
- The Pharmaceutical Manufacturing and Sales business is realizing a highly efficient model for both production and sales and is entering a stage of rapid profit growth

Results trends



Source: Prepared by FISCO from the Company's financial results

Results trends

Sales and profits increased in all three business segments and also greatly exceeded the initial forecasts

1. Overview of 1H FY3/20 results

FY3/20 is a so-called "skip year" for revisions* in which results are not affected by revisions to drug prices and dispensing fees. In this comparatively calm environment, the Company's aims include working to grow earnings, to strengthen the management structure, and to increase the competitiveness of each business.

* Although there were no revisions initially in April 2019, drug prices were revised from October 1, 2019, following the consumption tax hike. Therefore, strictly speaking, this is not a skip year for revisions. But 1H FY3/20 is a period in which the revisions had no impact on results.

Sales increased and profits grew significantly in 1H FY3/20 results, with net sales of ¥130,297mn (up 9.8% YoY), operating profit of ¥4,066mn (up 162.8%), ordinary profit of ¥4,001mn (up 216.2%), and profit attributable to owners of parent of ¥2,094mn (up 181.2%).

Overview of 1H FY3/20 results

(¥mn)

	1H FY3/19 results	1H FY3/20					FY3/20 forecast
		Forecast	Results	YoY	Vs. forecast	Progress rate	
Net sales	118,694	129,872	130,297	9.8%	0.3%	48.5%	268,599
Operating profit	1,547	2,862	4,066	162.8%	42.0%	56.2%	7,231
Ordinary profit	1,265	2,789	4,001	216.2%	43.5%	56.6%	7,069
Profit attributable to owners of parent	744	1,444	2,094	181.2%	45.0%	52.1%	4,020

Note: the progress rates are the percentages of the full fiscal year forecasts achieved in the 1H results
Source: Prepared by FISCO from the Company's financial results

In the 1H FY3/20 results, not only did profits increase significantly YoY, each profit item also greatly exceeded its initial forecast. In terms of the progress rates toward the full fiscal year forecasts as well, in 1H FY3/20, the progress rates for profits were greatly above 50%. When considering that, as a general rule, earnings in the Dispensing Pharmacy business are seasonal and are concentrated in the 2H, a progress rate of more than 50% can be said to be extremely high. On comprehensively considering this situation, the 1H FY3/20 results can be evaluated to be extremely strong.

Looking at the trends by business segment, sales and profits increased in all three businesses, of the mainstay Dispensing Pharmacy business, the Pharmaceutical Manufacturing and Sales business, and the Medical Professional Staffing and Placement business. On further analyzing the details, the Pharmaceutical Manufacturing and Sales business and the Medical Professional Staffing and Placement business, which together only provide around 20% of total net sales, provided approximately 50% of the increase in operating profit (¥2,518mn). Therefore the situation is that the balance of operating profit between the three business segments has improved greatly compared to previous years. In other words, these results reflect not only the numerical figures at face value, but also progress made in terms of the quality of the Company's earning's structure.

Breakdown by business segment

(¥mn)

		1H FY3/19 Results	1H FY3/20 Results	YoY growth rate	YoY change	Progress rate	FY3/20 forecast
Net sales	Dispensing Pharmacy business	101,054	111,763	10.6%	10,709	49.3%	226,908
	Pharmaceutical Manufacturing and Sales business	19,431	21,040	8.3%	1,609	46.2%	45,493
	Medical Professional Staffing and Placement business	6,351	6,775	6.7%	423	47.4%	14,300
	Before adjustment	126,837	139,579	10.0%	12,742	48.7%	286,701
	Adjustment	-8,143	-9,281	-	-1,138	-	-18,102
	Net sales total	118,694	130,297	9.8%	11,603	48.5%	268,599
Operating profit	Dispensing Pharmacy business	3,197	4,408	37.8%	1,210	50.1%	8,794
	Pharmaceutical Manufacturing and Sales business	344	1,155	235.7%	811	61.3%	1,884
	Medical Professional Staffing and Placement business	630	1,082	71.6%	451	58.5%	1,849
	Before adjustment	4,172	6,645	59.3%	2,473	53.0%	12,527
	Adjustment	-2,625	-2,579	-	46	-	-5,296
	Operating profit total	1,547	4,066	162.8%	2,518	56.2%	7,231

Source: Prepared by FISCO from the Company's financial results and results briefing materials

Both the number of prescription requests and the prescription unit price steadily grew, and sales increased by double digits
New-pharmacy openings were also progressed basically as planned

2. Dispensing Pharmacy business

In the Dispensing Pharmacy business in 1H FY3/20, sales and profits increased, with net sales of ¥111,763mn (up 10.6% YoY), gross profit of ¥16,153mn (up 13.8%), and operating profit of ¥4,408mn (up 37.8%). Compared to the initial forecasts as well, both sales and profits were above forecast.

Dispensing Pharmacy business profit and loss statement

(¥mn)

	1H FY3/19 Results	FY3/20 1H Plan	FY3/20 1H Results	FY3/20 YoY	FY3/20 Vs. plan
Net sales	101,054	109,021	111,763	10.6%	2.5%
Cost of sales	86,856	94,039	95,609	10.1%	1.7%
Gross profit	14,197	14,981	16,153	13.8%	7.8%
Gross profit margin	14.0%	13.7%	14.5%	-	-
SG&A expenses	10,999	11,212	11,745	6.8%	4.8%
Ratio of SG&A expenses to net sales	10.9%	10.3%	10.5%	-	-
Operating profit	3,197	3,769	4,408	37.8%	16.9%
Operating profit margin	3.2%	3.5%	3.9%	-	-
Number of dispensing pharmacies at the end of the period	596	615	611	2.5%	-0.7%
Net sales per dispensing pharmacy	171	179	184	8.0%	3.1%

Source: Prepared by FISCO from the Company's results briefing materials

As described in the previous reports, the April 2018 revisions to dispensing fees were extremely severe for hospital-adjacent pharmacies and for the major dispensing-pharmacy chains. To give an example from the past, in many cases the negative impact of the revisions was completely recovered during the same fiscal year, and rather, the second year would start with dispensing fees at a level higher than before the revisions. But in the case of the April 2018 revisions, the situation as of April 2019 was that there had not been a complete recovery to the pre-revisions level and that efforts were continuing to recover the level. But even in this severe situation, as described below, the Company was able to achieve steady growth for both the prescription unit price and the number of prescription requests, and net sales increased by double digits YoY.

Conversely, for profits, although there were factors increasing costs, including the recruitment of approximately 400 new-graduate pharmacists, which was a new record high, they were absorbed by the effects of the higher sales, so operating profit increased significantly, up 37.8% YoY. The operating profit margin also improved by 0.7 of a percentage point (PP), rising from 3.2% in the same period in the previous fiscal year to 3.9% in 1H FY3/20.

Of the Company's KPI (Key Performance Indicators) for the Dispensing Pharmacy business, the one that it particularly emphasizes is net sales per pharmacy. In 1H FY3/20, it achieved ¥184mn (¥368mn when converted to annually) for this, for an increase of 8.0% YoY (¥13mn) from ¥171mn year (¥352mn, annually) in the same period in the previous fiscal.

The Company is working to expand its network of pharmacies through organic (own) openings and M&A just like previous years, and in 1H FY3/20, it opened 20 new pharmacies, which was basically as planned.

(1) Conditions for the number of prescription requests and the prescription unit price

In the Dispensing Pharmacy business, net sales are determined by the product of the number of prescription requests and the prescription unit price. In 1H FY3/20, the number of prescription requests was 104.1% YoY, and the prescription unit price was 106.2%. As a result, net sales in this business were 110.6%.

Looking in further detail at the breakdown by pharmacy opening, the focus is on the fact that in existing pharmacies (pharmacies opened in previous fiscal years), both the prescription unit price (107.5%) and the number of prescription requests (101.7%) were higher than in the same period in the previous fiscal year, and that existing pharmacies' net sales were 109.3%. In the FY3/19 full year results, the prescription unit price and the number of prescription requests were slightly below their levels in the previous fiscal year, and net sales were only 99.1% YoY. As the Company's pharmacies rank top in the industry for net sales per pharmacy, there were concerns that there was limited room for growth, but it seems that these concerns were unfounded.

Details of dispensing net sales, the number of prescription requests, and the prescription unit price

	1H FY3/20		
	Dispensing net sales	No. of prescriptions	Prescription unit price
Existing pharmacies	109.3%	101.7%	107.5%
Pharmacies opened in FY3/19	389.9%	475.3%	82.0%
All pharmacies	110.6%	104.1%	106.2%

Source: Prepared by FISCO from the Company's results briefing materials

As previously stated, the number of prescription requests was 104.1% YoY and the actual number of prescriptions was 7,219,000. When observing by pharmacy opening, existing pharmacies, which indicate the actual situation, requests were 101.7% and showed steady growth. This becomes 104.1% on adding the increase from the pharmacies opened in the previous fiscal year, and this growth rate is higher than the rates of 102.6% in 1H FY3/19 and 103.3% in the FY3/19 full year.

On the other hand, the prescription unit price in 1H FY3/20 was 106.2% YoY. Breaking this down, the unit price was 107.5% for existing pharmacies and 82.0% for pharmacies opened in the previous fiscal year. There were broadly three factors causing the prescription unit price to change; drug prices, changes to the configuration of prescribed drugs, and dispensing fees. In 1H FY3/20, dispensing fees improved by approximately 3%, and it seems that the remainder was due to differences in the drug configuration. When considering the severity of the content of the April 2018 revisions to dispensing fees, at FISCO, we estimate that the prescription unit price in 1H FY3/20 trended at a satisfactory level.

(2) Pharmacy opening-closing conditions

For the FY3/20 full year, the Company planned to open 45 new pharmacies, while in the six-month period of 1H FY3/20, it opened 20 new pharmacies. Breaking this down, 16 pharmacies were organic openings and 4 pharmacies were from M&A. Conversely, it closed 7 pharmacies, for a net increase of 13 pharmacies. The total number of pharmacies increased from 598 pharmacies at the end of March 2019 to 611 pharmacies at the end of September 2019. Also, in the developments in 1H FY3/20, 1 of the 2 product-sales pharmacies was closed and reopened as a dispensing pharmacy. As a result, of the 611 pharmacies, 610 are dispensing pharmacies and 1 is a product-sales pharmacy.

Pharmacy transfer conditions in 1H FY3/20

	End of FY3/19	Opened		Closed	End of FY9/19
Dispensing pharmacy	596	Organic opening	16	6	610
		M&A	4		
Stall pharmacy	2	0		1	1
Total	598	20		7	611

Source: Prepared by FISCO from the Company's financial results and results briefing materials

The Company's pharmacies are divided and managed into two types; the hospital-adjacent type (including on-site pharmacies opened within hospital premises) and the hybrid type (a concept that combines the foot traffic-type and medical mall-type, which were the previous divisions, to widen the targeted medical facilities and to increase the number of pharmacy visitors). As mentioned above, the Company opened 20 pharmacies in 1H FY3/20, and breaking this down, 8 were hospital adjacent-type pharmacies (of which, 4 were on-site pharmacies) and 12 were hybrid-type pharmacies.

This pharmacy-opening balance of 4:6 is a good one. The Company has judged that the positive effects of the on-premises-type, which include improving pharmacists' skills and strengthening cooperation with medical facilities, are greater than their negative impact on dispensing fees. Therefore, its stance is to actively open these pharmacies if it has the opportunity to do so.

In terms of regions, in 1H FY3/20, nearly half of the pharmacy openings, of 9 pharmacies, were in the Kanto region, and 4 pharmacies were in each of the Kansai and Hokuriku regions. Breaking down the total of 611 pharmacies, nearly half, of 301 pharmacies, are in the Kanto region, and the remainder are distributed with a good balance across the various regions. From the comparison with the population-distribution ratios, the impression is that there is still plenty of room for growth in the Kansai region.

Distribution of pharmacies by region

	1H FY3/20			Population-distribution ratio
	No. of pharmacies during the period	No. of pharmacies at the end of the period	Percentage of total at the end of the period	
Hokkaido	0	43	7.0%	4.2%
Tohoku	2	45	7.4%	7.1%
Kanto	9	301	49.3%	33.8%
Koshinetsu	0	23	3.8%	4.1%
Tokai	2	53	8.7%	11.8%
Kansai/Hokuriku	4	69	11.3%	18.7%
Chugoku/Shikoku	2	39	6.4%	8.9%
Kyushu/Okinawa	1	38	6.2%	11.4%
Total	20	611	100.0%	100.0%

Note: Analysis of 8 regions for the 611 pharmacies at the end of September 2019. The population-distribution ratios are based on the National Census (2015).
Source: Prepared by FISCO from the Company's results briefing materials

Sales are growing steadily to inside and outside of the Group. Continues to benefit from the Japanese government's Guidelines for the Improvement of Commercial Transaction Practices of Ethical Drugs, and the profit margin improved significantly

3. Trends in the Pharmaceutical Manufacturing and Sales business

In the Pharmaceutical Manufacturing and Sales business in 1H FY3/20, sales and profits increased, with net sales of ¥21,040mn (up 8.3% YoY), gross profit of ¥3,397mn (up 13.8%), and operating profit of ¥1,155mn (up 235.7%). Compared to the initial forecasts, net sales and gross profit were below forecast, but operating profit was greatly above forecast due to the major reduction in SG&A expenses.

Pharmaceutical Manufacturing and Sales business profit and loss statement

(¥mn)

	1H FY3/19 Results	FY3/20			
		1H Plan	1H Results	YoY	Vs. plan
Net sales	19,431	22,480	21,040	8.3%	-6.4%
Cost of sales	16,444	18,732	17,643	7.3%	-5.8%
Gross profit	2,986	3,748	3,397	13.8%	-9.3%
Gross profit margin	15.4%	16.7%	16.1%	-	-
SG&A expenses	2,642	2,921	2,242	-15.1%	-23.2%
Ratio of SG&A expenses to net sales	13.6%	13.0%	10.7%	-	-
Operating profit	344	826	1,155	235.7%	39.7%
Operating profit margin	1.8%	3.7%	5.5%	-	-

Source: Prepared by FISCO from the Company's results briefing materials

The Company's Pharmaceutical Manufacturing and Sales business is leveraging its strength of having a top-class domestic chain of dispensing pharmacies within the Group to actively grow internal sales. In addition, based on this, its strategy is to aim to increase external sales as well. In 1H FY3/20, internal net sales increased 15.7% YoY to ¥9,256mn, mainly due to the effects of the volume-based expansion and the new-pharmacy openings in the Dispensing Pharmacy business. Also, external sales increased 3.1% to ¥11,783mn, because the Company strengthened its measures for new sales channels, including for contracted production and licensing-out.

In profits, operating profit increased 235.7% YoY to ¥1,155mn, mainly due to the effects of the higher profits from the rise in sales, and the improvement in the gross profit margin from a sales strategy prioritizing profitability, based on the Japanese government's distribution improvement guidelines.

At FISCO, we think that the point to focus on in the 1H FY3/20 results is the significant improvement in the operating profit margin. It was 1.8% in the same period in the previous fiscal year, but in 1H FY3/20, it rose sharply to 5.5%. The Company has worked since the past to improve the operating profit margin, but it is benefiting from the distribution improvement guidelines published by the Ministry of Health, Labour and Welfare in January 2018, and in 2H FY3/19, the operating profit margin improved remarkably and achieved 4.6% for the full fiscal year. This development has continued in FY3/20 also, which is considered to be the first reason for the improved profit margin. In addition to this, in 1H FY3/20, the Company strengthened sales of highly profitable products from among the sales items it handles (675 items in total). It seems that this measure is proving successful and caused the operating profit margin to improve even more.

As stated in the medium-term growth strategy section, on the one hand, capital investment in the Pharmaceutical Manufacturing and Sales business segment has peaked-out, but on the other hand, the Company is enhancing measures to improve the operating rates at plants. Going forward, at FISCO, we think that it has entered a stage for profits in which both the profit amount and profit margin will grow rapidly.

Secured higher sales through increasing the number of pharmacists placement projects
Profits increased significantly, as upfront investment in new businesses has peaked-out.

4. Trends in the Medical Professional Staffing and Placement business

In the Medical Professional Staffing and Placement business in 1H FY3/20, sales and profits increased, with net sales of ¥6,775mn (up 6.7% YoY), gross profit of ¥2,903mn (up 21.9%), and operating profit of ¥1,082mn (up 71.6%). Compared to the initial forecasts, net sales were below forecast, but gross profit and operating profit were above forecast.

Medical Professional Staffing and Placement business profit and loss statement

(¥mn)

	1H FY3/19 Results	FY3/20			
		1H Plan	1H Results	YoY	Vs. plan
Net sales	6,351	7,041	6,775	6.7%	-3.8%
Cost of sales	3,969	4,263	3,871	-2.5%	-9.2%
Gross profit	2,382	2,778	2,903	21.9%	4.5%
Gross profit margin	37.5%	39.5%	42.9%	-	-
SG&A expenses	1,751	1,888	1,821	4.0%	-3.6%
Ratio of SG&A expenses to net sales	27.6%	26.8%	26.9%	-	-
Operating profit	630	889	1,082	71.6%	21.7%
Operating profit margin	9.9%	12.6%	16.0%	-	-

Source: Prepared by FISCO from the Company's results briefing materials

One sales-increase factor cited is the progression of the shift from staffing to placements for the mainstay pharmacists. The staffing business is a recurring income-type model, in which income is continuously generated, whereas placements is a flow-type model in which placements commissions are obtained, which is a factor pushing up sales. The second factor cited is the expansion of the doctor placements business. As the placements fees for doctors are high with high profit margins, every company, including the Company, is focusing on this field. But up to the previous fiscal period, it had implemented structure-strengthening measures, including to establish bases and to increase the number of sales personnel, and these measures contributed in 1H FY3/20 and the doctor placements business grew.

The direct reason for net sales being below forecast was the decline in staffing demand compared to the forecast. In the background to this are factors in the various companies in which pharmacists are staffed, including the higher functions being demanded of pharmacies and the increasing need for the long-term development of human resources. There is also the aspect of the Company's pharmacist placements business growing from the effects of the change from staffing to direct employment and other forms of employment.

In profits, operating profit increased significantly YoY. This was mainly due to the increase in profits as an effect of the higher sales and the decrease in costs because upfront investment (including to acquire human resources for the doctor placements business), which had continued up to the previous fiscal period, peaked-out.

Medium- to long- term growth strategy and its progress

There have been no changes since previously to the basic structure of the medium- to long-term strategy being implemented based on the Long-Term Vision for 2030, which aims for net sales of ¥1tn

1. Summary of the medium- to long-term growth strategy

In April 2018, the Company announced the Long-Term Vision for 2030. Its content is described in detail in the report dated June 11, 2018, but in terms of its key points, it describes how the Company will overcome the changes in the social structure within Japan (including the progress toward an ultra-aging society) and the increasing demands to reduce medical costs, and also the environmental changes, such as the advanced functions being required of pharmacies and the weeding-out of dispensing pharmacies. It states that, starting with the Dispensing Pharmacy business, it will dramatically expand each business toward achieving a corporate scale of net sales of ¥1tn by 2030. The approach of placing the Long-Term Vision for 2030 as the basis for the medium- to long-term growth strategy has been inherited by President and CEO Yosuke Mitsuhara, who was appointed in June 2019.

Breaking down operating profit from net sales of ¥1tn, which is the numerical target in the Long-Term Vision, it is envisaged that 50% will be provided by the Dispensing Pharmacy business and the remaining 50% will be the total of the other businesses, mainly the Pharmaceutical Manufacturing and Sales business and the Medical Professional Staffing and Placement business. Toward achieving this target, there have been no changes since previously to the basic structures of the growth strategies for each business segment. The developments in each segment are described below.

Following the 2019 revisions to the Pharmaceutical and Medical Device Act, there may be major developments in the dispensing-pharmacies industry
The importance of human resources is increasing, and the Company is currently steadily progressing preparations for this

2. The measures and progress made for medium- to long-term strategy in the Dispensing Pharmacy business

(1) Current conditions for the Dispensing Pharmacy business

In the business of dispensing pharmacies (also called insurance pharmacies in Japan), the business form itself--pharmacies--are defined within the Japanese government's health insurance system. Therefore, it is considered that greater effects can be expected when the direction taken by a company is in line with the direction of the systemic reforms being advanced by the government (the Ministry of Health, Labour and Welfare).

As previously mentioned, FY3/20 is a skip year for the revisions to dispensing fees, but a bill to revise the Pharmaceutical and Medical Device Act was submitted to the 198th session of the Diet in March 2019. After that, deliberations continued in the Diet, and then in its 200th session (the session from October 4, 2019 to December 9, 2019), it was approved and established in the House of Councilors' plenary session of November 27. The new pharmacy functions certification system and other revisions will be enforced within two years from its promulgation in the official gazette.

The contents of these revisions to the Pharmaceutical and Medical Device Act include not only the revisions to dispensing fees scheduled for April 2020, but also revisions that will have major impacts on the roles and nature of pharmacies and pharmacists in the future. Therefore, it is important that the Company and other companies conducting dispensing pharmacy businesses examine its content, make predictions about the future, such as the changes to the business environment, and then progress their responses to them as quickly as possible. Below is an overview of the revised Pharmaceutical and Medical Device Act, and the progress made by the Company for its medium- to long-term growth strategy.

(2) The key points of the revised Pharmaceutical and Medical Device Act

In the current revised Pharmaceutical and Medical Device Act, the nature of pharmacists and pharmacies have been reviewed. But as an introduction to this, it is first clearly stated that the reason for the review is "so that patients can use pharmaceuticals with peace of mind in the local communities where they are used to living." The background leading to this statement is that, while the separation of medical and dispensing services is progressing (the prescription-receipt rate in FY17 was above 70%, at 72.8%), there has been no patient-centered separation. Thus the current situation is that an awareness has formed in which it is considered that the expected effects and functions of this separation of medical and dispensing services are not being demonstrated.

The content of the revised Act that relates specifically to pharmacies and pharmacists can be broadly divided into four points: 1) the introduction of pharmacies by function, of "regional-cooperation pharmacies" and "specialized medical facilities cooperation pharmacies," 2) it has been made legally mandatory for pharmacists to continuously ascertain patients' medication situations and to provide them with medication guidance; 3) the introduction of medication guidance through video calls and other methods, and 4) the maintenance of systems for legal compliance and related laws by pharmacies. All are important, but the one which is considered to be particularly important and that will have a major impact on companies conducting a dispensing pharmacy business is 1), the introduction of types of pharmacies according to two functions.

In 2015, the Ministry of Health, Labour and Welfare formulated and published the Vision of Pharmacies for Patients (which has been discussed several times in previous reports). Within it are shown the specific approaches for the functions required of pharmacies, of "family pharmacists and pharmacies" and "advanced pharmaceutical management functions," and it can be said that the current revised Pharmaceutical and Medical Device Act systemizes these approaches. In this sense, the current introduction of these two types of pharmacies can be viewed as an extension of the existing line, but their impacts on companies conducting dispensing pharmacy businesses will certainly not be small.

The first concern is that there will be a ranking (or " gaps" will appear) for those pharmacies certified as either of the two types (for convenience, below these are called "certified pharmacies") and non-certified pharmacies (at FISCO, we consider that initially, the majority of pharmacies will be non-certified pharmacies), and that as a result, major differences may appear in terms of attracting customers and generating sales. Originally, the aim of introducing these two types was to "enable patients to select the pharmacy best suited to them," and it is even possible that the government will take the lead in conducting public relations activities for the features and functions of certified pharmacies. Therefore, in the event that patients become strongly orientated toward the certified pharmacies, major differences may arise depending on whether or not certification has been obtained. As a typical example, we can consider cases of the weeding-out of the hospital-adjacent pharmacies that are located in front of hospitals.

The second concern is that the hurdles to acquiring the certification may be higher than expected. The certification criteria are determined by an ordinance of the Ministry of Health, Labour and Welfare (the certification itself is carried out by the prefectural governor based on these criteria). The details have not yet been clarified, but it can be expected to be carried out in the same vein as the health-support pharmacies and family pharmacies described in the Vision of Pharmacies for Patients. In this case, it would seem necessary to clarify aspects such as the relationships and roles of these newly introduced certified pharmacies and the differences in their merits. If this appears in the form of the severity of the certification conditions, the burden placed on companies conducting a dispensing pharmacy business will increase and the number of certified pharmacies (or their percentage of all pharmacies) will not rise as much. In the debate on the revisions to the Act, the question has already been asked regarding how pharmacy pharmacists who have not worked in a hospital and do not have experience of patients' severe side effects will be responsible for the indicated advanced pharmaceutical management functions. When honestly deciphering these developments, it is considered that pharmacists who work in certified pharmacies may need to possess considerably high levels of experience, skills, and qualifications.

Even other than the above, other various hurdles may emerge alongside the enforcement of the revised Act. On the other hand, the revisions may also have positive aspects, as it is considered that the introduction of medication guidance through video calls and other aspects will lead to earnings opportunities and improved work efficiency.

From the viewpoint of investors, points that should be considered for the current revised Pharmaceutical and Medical Device Act are the various types of pharmacies (as there are many ways to categorize them, including according to whether a large-scale chain, a corporation-managed medium- to small-scale, or individually managed pharmacy; according to whether a hospital-adjacent or a foot-traffic type pharmacy; and according to whether a dispensing or a drug-store pharmacy) and which type of pharmacy will be the first to fall. At FISCO, we consider that individually managed pharmacies can be expected to disappear, as they have historically been weak in terms of pure management strength. However, on looking at aspects such as the history and the results of the policy guidance of the Ministry of Health, Labour and Welfare through its revisions to dispensing fees, the view is changing that individually managed pharmacies do not necessarily have a weak presence. Conversely, on looking at the recent revised Pharmaceutical and Medical Device Act, it is expected that progressing the responses to the revisions will increase the burden placed on each individual pharmacy. It is possible that individually managed pharmacies will be weeded-out from the start in these responses, but it is anticipated the individually managed pharmacies will have to respond to the revisions (for example, by aiming to become certified pharmacies), even if corporations including major chains that are larger than a certain scope can ignore the "certification sign." At FISCO, we think that such efforts will entail a fair degree of risk. This is easy to understand if they were to overlap with the current situation, of the approach of a major turning point for convenience store management.

When looking back at some point in the future, as it has been said that "the 2019 revisions to the Pharmaceutical and Medical Device Act were the trigger for the full-scale restructuring of the industry," at FISCO we think that the revised Act will have a significant impact, even if only in this way.

(3) Medium- to long- term growth strategy and its progress

It goes without saying that the growth strategy of the Company (and also for other companies in the same industry) will not be formed in a way unrelated to the legal and systemic changes described above. The concerns mentioned above apply unchanged to the Company. However, it has clearly ascertained and understood the approach of the government (of the Ministry of Health, Labour and Welfare) that has been incorporated into the Vision of Pharmacies for Patients, and it has been advancing preparations for this for some time. Therefore, at FISCO, we think that its impact on the current revisions to the Pharmaceutical and Medical Device Act will be relatively small.

The basic structure of the Company's growth strategy has been consistent and unchanging since the past. On simply summarizing it, it might be described as points a) to f) below.

a) Industry reorganization is inevitable, and in this situation, it is aiming to "expand shares through successful survival."
b) As the specific methods for this, it is steadily progressing "opening pharmacies" and "expanding the network of pharmacies."
c) When opening pharmacies, it will open them in line with the Japanese government's "Vision of Pharmacies for Patients."
d) When expanding the network of pharmacies, it will utilize openings by the Company itself (organic openings) and M&A.
e) As the KPI (Key Performance Indicator), "net sales per pharmacy" is closely related to the items in c) and d).
f) It goes without saying that human resources are essential in order to put the medium-term growth strategy into practice, and it will conduct upfront "investment in human resources."

Due to the current revisions to the Pharmaceutical and Medical Device Act, it is possible that in c), the expression will change to "Expand the two types of certified pharmacies in the Pharmaceutical and Medical Device Act," but essentially, this would not be a major change.

The component elements of its growth strategy include the pharmacy network and the number of pharmacies, pharmacy openings, and investment in human resources, and there have been no major changes from the details described in the previous report (June 10, 2019). Below, we will introduce the points that emerged during the Company's first results briefing session since the appointment of President and CEO Yosuke Mitsuhara.

1) The number of pharmacies

The Company ranks second in the industry for net sales, but in 5th or 6th position for the number of pharmacies. In order to fill in this difference, it has positioned net sales per pharmacy as a KPI, and it forms the basis for various management decisions.

At the recent results briefing session, President and CEO Yosuke Mitsuhara mentioned the possibility of thinking a little more aggressively about the number of pharmacies. This does not mean relaxing the standards for organic pharmacy openings and M&A that the Company has maintained up to the present time, but rather indicates that it will adopt a slightly more aggressive attitude. In the background to this is the sense of responding to the fact that, even if the current standards are maintained unchanged, the number of M&A proposals that will become available for investigation is likely to increase in the future compared to up to the present time.

One of the Company's standards is to open 50 new pharmacies a year (the total from organic openings and M&A; in FY3/20, it will open a total of 45 pharmacies). This number may be revised in the future, but what would seem to be easier to understand a change in the Company's stance is whether or not the number of pharmacies it opens through M&A is clearly increasing.

At FISCO, we think that up to the present time, the Company has conducted individual pharmacy management extremely skillfully. However, as previously stated, due to the revisions to the Pharmaceutical and Medical Device Act, pharmacy management on the unit of individual pharmacies is expected to become much more difficult. From the viewpoint of investors, what we think is important is to once again review and discuss (on the Company side) questions such as on what timing will it be the most efficient to step on the accelerator and increase the number of pharmacies, and will the standards for M&A and opening new pharmacies be changed by the revisions to the Pharmaceutical and Medical Device Act.

2) The acquisition and development of human resources

The Company prioritizes improving the quality of its pharmacists and has established various training systems and in-Company education and qualification systems. It has worked to create a virtuous circle, in which appealing to potential recruits on these points enables it to acquire human resources, including new graduates, which causes earnings to increase, which in turn enables it to further invest in human resources and to improve their quality and earnings. It can be said to have established this virtuous circle up to the present time, and at FISCO, we think one specific result of it was its recruitment of approximately 400 new graduates in April 2019. It intends to continue to further refine this circle in the future.

The Company plans to recruit 350 new graduates in April 2020, which clarifies the sense that recruitment has peaked-out. Instead, it intends to work to further improve the retention rate of existing employees and to improve their quality by strengthening training. At FISCO, we think this decision is absolutely the correct one. It is clear that the work and skills required of pharmacists is transitioning from working mainly with products to working one-to-one with people. It is also considered that the introduction of certified pharmacies through the revisions to the Pharmaceutical and Medical Device Act suggests pharmacists must move to an even higher stage in terms of skills and quality. Therefore, as well as the number of pharmacists under its umbrella, it seems that their composition, such as their ages and skills levels, has become more important than ever before. As a major premise of this, realizing a high retention rate can be said to also become more important. At FISCO, our understanding is that the Company's statement of moving "toward the second stage of a virtuous circle for human resources" is intended for this, and going forward, we shall be paying close attention to how this will bring about the policies it formulates, how it differentiates itself from other companies, and its earnings growth.

For the expansion of contracted production, currently the focus is on raising-up the operating rates of plants. The Company is realizing a highly efficient model for both production and sales and entering a stage of rapid profit growth.

3. Measures and progress made for medium- to long-term growth in the Pharmaceutical Manufacturing and Sales business

In the Long-term Vision toward 2030, the Company sets the target of acquiring a market share of 15% for the Pharmaceutical Manufacturing and Sales business. The significance of this value of 15% is that it means it will be one of the surviving companies, based on the view that generic pharmaceutical manufacturers will be consolidated into 5 or 6 companies in the future. The setting of this target and the growth strategy to achieve it were described in the previous report, and there have been no major changes.

At the end of 1H FY3/20, what we are focusing on is the measures to reduce production costs in the production system, and in particular, as the specific strategy, the measures to expand contract-production items. As was stated in the results trends section, in 1H FY3/20 in sales, the Company leveraged its strength of having a top-class domestic chain of dispensing pharmacies within the Group to realize earnings growth, and it has succeeded in establishing a business model unique to the Company Group. The next issue will be the production (manufacturing) aspect. If a business model can be established for this as well, the Company's Pharmaceutical Manufacturing and Sales business will have in place an "equation for success" for both manufacturing and sales, so profitability can be expected to be raised even higher.

In April 2018, the Company completed Tsukuba Plant No.2, which started shipping products from November of the same year, and since then its operations have continued smoothly. Due to the completion of a two-plant system, of the Tsukuba Plant and Tsukuba Plant No.2, in March 2019 it sold the Kasukabe Plant, so the situation is that it has been trimming excess fat.

It has been "trimming excess fat" in the same way financially as well. Capital investment peaked at ¥18.7bn in FY3/17, falling as far as ¥1.5bn in FY3/19. At FISCO, we think that in the future, the amount will basically trend in a range of ¥3.0bn to ¥5.0bn a year for maintenance and partial replacements investment (it plans capital investment of ¥3.8bn in FY3/20). However, depreciation expenses have risen rapidly, up ¥0.9bn YoY to ¥3.5bn in FY3/19, although the plan for FY3/20 is for only a ¥0.1bn increase to ¥3.6bn. The amount is expected to trend basically unchanged from this from FY3/21 onwards.

In this situation, the operating rates of facilities at plants will have an extremely large impact on how earnings, particularly profits, will fluctuate. Pharmaceutical plants are different to the blast furnaces of steel manufacturers and the naphtha crackers of petrochemical manufacturers, even though all are manufacturing plants, and it is not the case that close to a 100% operating rate can be achieved. This is because it is considered important to keep excess supply capacity. That said, they are the same on the point of the importance of maintaining the operating rate above a certain level, and toward achieving this, the Company is focusing on expanding the contracted production of pharmaceuticals. In the year and a half since the completion of the Tsukuba Plant No.2 up to the present time, it has acquired contracts for 17 contract-production items. Moreover, below the surface and continuing from this, it seems it is progressing negotiations for more contracts for contract-production items

One of the features of Tsukuba Plant No.2 is its strength in the mass production of the same item. Therefore, for contracted production, the Company is not pursuing small-volume multiple-item production, or in other words, the production of many items, but rather it seems to be working to acquire contracts for items with large production volumes.

It is considered that the contracted-production operations will become fully fledged from 2H FY3/20. Up to the present time, in sales, the improvement to business conditions has played a large role in improving the earnings of the Pharmaceutical Manufacturing and Sales business. But going forward, the Company is expected to focus on the manufacturing aspect as an earnings-growth factor. If it makes steady progress for this, it will have established a highly efficient business model for both manufacturing and sales, which at FISCO we expect will lead to a period of rapid earnings growth in the Pharmaceutical Manufacturing and Sales business.

Start of fully fledged operations of the doctor placements business, which is expected to be the next generation growth driver

4. Measures and progress made in medium- to long-term growth in the Medical Professional Staffing and Placement business

The Medical Professional Staffing and Placement business has realized growth up to the present time with the pharmacist staffing business serving as the core business. The Company intends to realize growth in the future by shifting from staffing to placements in the pharmacist business and strengthening measures for doctors (placements) and registered sales staff (placements) when expanding the occupations that it handles. It is continuously working on this in FY3/20 also.

In the last few years, the Company had conducted upfront investment toward strengthening the doctors placements business, including establishing sales bases and increasing the number of personnel, and it completed this in FY3/19. The awareness of the situation is that from FY3/20, it is transitioning to a period of fully fledged business development and the recovery of the investment through earnings growth. Reflecting this, as previously stated, sales and profits increased in this segment’s 1H results.

However, when solely extracting the doctor placements business, it would seem necessary to be cautious about whether it will trend as expected. Those companies that advanced into the doctor placements field ahead of the Company have overwhelming high market shares and name recognition, so there cannot be excessive expectations that the Company will instantly grow rapidly in this field.

In pharmacist staffing, the Company has been establishing a strong sales foundation. While utilizing this, such as for collaborations, at FISCO we think that it can steadily increase its presence in the doctor placements fields as well, even if it takes some time. Therefore, we will be paying attention to growth in this endeavor in the future.

Compared to the other businesses, the doctor placements business has a high unit price and high earnings. Once this business gets on track, it can be expected to have an extremely large impact on earnings.

The Company also expects to make a fully-fledged start to the registered salesperson placement business. The total number of registered sales staff is 200,000 people and the market is trending at job offers for around 10,000 people. Placements are at sites such as convenience stores, supermarkets, and drug stores. It seems that it is aiming to establish the business foundations at an early stage for registered salesperson placement to become the third main pillar, after pharmacists and doctors.

Business Outlook

Adopting a cautious stance, while the full fiscal year results are expected to exceed the forecasts

For FY3/20, the Company is forecasting net sales of ¥268,559mn (up 9.3% YoY), operating profit of ¥7,231mn (up 7.4%), ordinary profit of ¥7,069mn (up 16.3%), and profit attributable to owners of parent of ¥4,020mn (up 6.1%). These values have been left unchanged from the initial forecasts.

Summary of FY3/20 outlook

(¥mn)

	FY3/19			FY3/20				
					2H		Full year	
	1H results	2H results	Full-year results	1H results	Forecast	YoY	Forecast	YoY
Net sales	118,694	126,993	245,687	130,297	138,302	8.9%	268,599	9.3%
Operating profit	1,547	5,186	6,733	4,066	3,165	-39.0%	7,231	7.4%
Ordinary profit	1,265	4,812	6,077	4,001	3,068	-36.2%	7,069	16.3%
Profit attributable to owners of parent	744	3,046	3,790	2,094	1,926	-36.8%	4,020	6.1%

Source: Prepared by FISCO from the Company's financial results

As stated above, in 1H FY3/20, sales and profits increased in all three segments. Compared to the forecasts as well, operating profit exceeded the forecast in every segment. But despite this situation, the Company has left the initial full fiscal year results forecasts unchanged. As a result, the hurdles to be cleared to achieve the 2H forecasts (as these amounts are the 1H results subtracted from the full fiscal year forecasts, more accurately, they are “the earnings amounts required in the 2H to achieve the full fiscal year forecasts) have been substantially lowered. Specifically, the levels are for net sales to increase 8.9% YoY to ¥138,302mn, but operating profit to decrease 39.0% to ¥3,165mn.

From this situation, the current full fiscal year forecasts appear too conservative, so expectations have risen that they will be upwardly revised in this future. But on this point, our opinion is that it is necessary to temporarily stop and think cautiously.

One reason for thinking in this way is the revisions to drug prices in October 2019. They have been positioned as simply an “adjustment” following the hike to the consumption tax, but on opening them up and looking inside, we see their content is quite deep. They will affect both the Dispensing Pharmacy business and the Pharmaceutical Manufacturing and Sales business, and this has meant that the Company has had to brace for their impact, which led to it maintaining the full fiscal year forecasts.

At FISCO, we think it is highly likely that the full fiscal year results will exceed the forecasts. However, we consider that at the current time, we should refrain from excessive expectations as to whether the extent that they will do so will exceed the standard for the timely disclosure of upward revisions. The same as the Company, we are looking carefully at the impact of the revisions to drug prices, while in addition, due to the revisions to the Pharmaceutical and Medical Device Act, it is possible that needs will arise for new upfront investment. Therefore, we think it would be not too late to wait to see the 3Q results before increasing expectations for upward revisions.

The progress made in each business segment and the points to focus on in the 2H overlap with the description in the medium- to long-term growth strategy section. There are few concerns about the above described numerical results, and rather what is considered to be more importance is what areas will the Company deepen when looking toward FY3/21 and beyond.

On briefly describing only the main points, more than the 2H FY3/20 results, it seems that the key themes in the Dispensing Pharmacy business will be the content of the revised Pharmaceutical and Medical Device Act, which is expected to have a major impact from FY3/21 onwards, and the policy responses to it and the research and analysis, such as for cost estimates.

In the Pharmaceutical Manufacturing and Sales business, the key themes are plant operating conditions and production costs, while the important points will include the conditions for acquiring new contract-production contracts that will support these themes.

For the Medical Professional Staffing and Placement business, the main points can be said to be the progress made in the new business, of the doctor placements business, and the measures for the third business (registered sales staff and nurses).

Income statement and the main indicators

(¥mn)

	FY3/16	FY3/17	FY3/18	FY3/19	FY3/20	
					1H	Full year (forecast)
Net sales	219,239	223,468	241,274	245,687	130,297	268,599
YoY	20.6%	1.9%	8.0%	1.8%	9.8%	9.3%
Gross profit	39,068	39,258	43,837	41,975	22,439	45,824
Gross profit margin	17.8%	17.6%	18.2%	17.1%	17.2%	17.1%
SG&A expenses	28,578	30,738	33,250	35,242	18,373	38,593
Ratio of SG&A expenses to net sales	13.0%	13.8%	13.8%	14.3%	14.1%	14.4%
Operating profit	10,489	8,519	10,587	6,733	4,066	7,231
YoY	57.8%	-18.8%	24.3%	-36.4%	162.8%	7.4%
Operating profit margin	4.8%	3.8%	4.4%	2.7%	3.1%	2.7%
Ordinary profit	9,878	7,976	10,138	6,077	4,001	7,069
YoY	64.6%	-19.3%	27.1%	-40.1%	216.2%	16.3%
Profit attributable to owners of parent	6,329	4,638	6,104	3,790	2,094	4,020
YoY	127.8%	-26.7%	31.6%	-37.9%	181.2%	6.1%
EPS after adjustment for stock split (¥)	432.85	290.03	381.69	243.47	139.71	268.17
Dividend per share after adjustment for stock split (¥)	45.00	50.00	50.00	50.00	25.00	50.00
BPS after adjustment for stock split (¥)	2,030.22	2,278.70	2,595.00	2,739.04	-	-

Note: The Company conducted a two-for-one stock split on October 1, 2015
Source: Prepared by FISCO from the Company's financial results

Balance sheet

(¥mn)

	End of FY3/16	End of FY3/17	End of FY3/18	End of FY3/19	End of 1H FY3/20
Current assets	84,838	82,327	81,613	80,132	81,586
Cash and deposits	32,385	21,200	28,464	29,749	29,165
Accounts receivable, etc.	26,810	27,643	21,230	17,848	17,506
Inventories	22,016	29,514	28,224	29,465	31,800
Fixed assets	72,770	96,019	104,956	98,545	97,748
Tangible fixed assets	51,997	68,513	75,662	69,806	69,212
Intangible fixed assets	10,122	16,773	17,952	16,906	16,669
Investments, etc.	10,650	10,733	11,341	11,833	11,865
Total assets	157,609	178,347	186,569	178,677	179,334
Current liabilities	68,985	66,305	70,310	69,100	67,680
Accounts payable, etc.	44,653	41,033	39,973	40,355	46,145
Short-term debt, etc.	12,963	13,411	15,309	16,143	9,676
Fixed liabilities	56,151	75,595	74,752	68,504	68,849
Long-term debt, etc.	50,621	70,678	68,372	62,470	62,947
Shareholders' equity	32,507	36,345	41,648	41,196	42,915
Capital	3,953	3,953	3,953	3,953	3,953
Capital surplus	10,926	10,926	10,926	10,926	10,926
Retained earnings	17,672	21,511	26,816	29,815	31,535
Treasury stock	-44	-46	-47	-3,498	-3,499
Total accumulated other comprehensive income	-34	101	-144	-127	-116
Total net assets	32,473	36,447	41,506	41,073	42,804
Total liabilities and net assets	157,609	178,347	186,569	178,677	179,334

Source: Prepared by FISCO from the Company's financial results

Cash flow statement

(¥mn)

	FY3/16	FY3/17	FY3/18	FY3/19	1H FY3/20
Cash flow from operating activities	19,327	-940	23,141	13,572	9,866
Cash flow from investing activities	-7,823	-28,444	-13,843	-1,770	-3,506
Cash flow from financing activities	7,031	18,205	-2,034	-10,516	-6,944
Change in cash and deposits	18,535	-11,180	7,264	1,284	-584
Cash and deposits at beginning of period	13,844	32,380	21,200	28,464	29,749
Cash and deposits at end of period	32,380	21,200	28,464	29,749	29,165

Source: Prepared by FISCO from the Company's financial results

Shareholder returns

Announced a dividend forecast for FY3/20 of ¥50, unchanged YoY

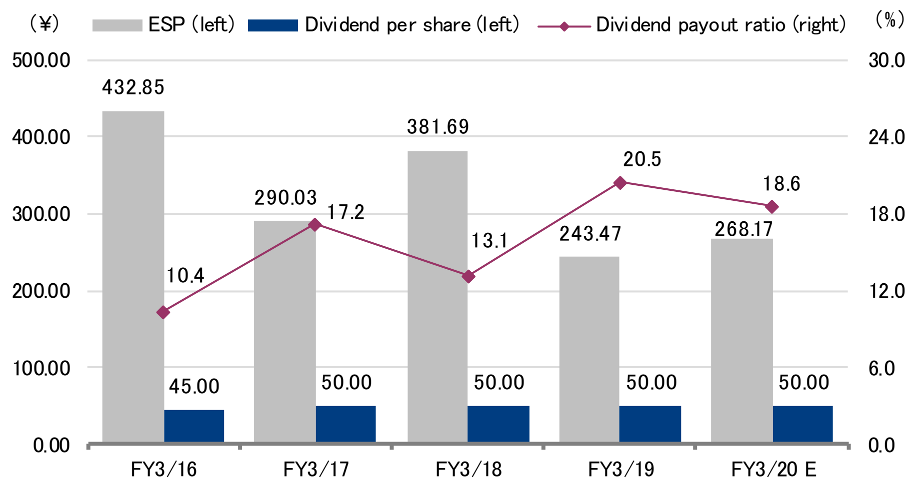
The Company's basic approach to shareholder returns is to pay dividends linked to business performance while ensuring it maintains the internal reserves necessary for growth.

For the FY3/20 dividend, the same as for the results forecasts, the Company has left the initial forecast unchanged, that the dividend will be unchanged YoY at ¥50.00 (interim dividend of ¥25.00 and period-end dividend of ¥25.00). Based on the earnings per share (EPS) of ¥268.174, the dividend payout ratio will be 18.6%.

Sales and profits are forecast to increase in FY3/20. Our viewpoint at FISCO remains unchanged from before; while profits grew in FY3/19, they remained substantially below their peak levels in the past, and the Company is aware of the need to prepare for the April 2020 revisions. This is amidst the background of the Company's decision to announce that the dividend forecast will stay the same YoY.

As explained above, the 1H FY3/20 results were strong, so at FISCO we think it highly likely that the full fiscal year forecasts will be achieved. However, we consider that it is necessary to be cautious on whether the extent that they will exceed the forecasts is sufficiently large to meet the standard for the timely disclosure of upward revisions. At the current time, we feel secure about the main scenario, of a dividend settled on ¥50.00, just as the Company forecast.

Trends in ESP, dividend per share and the dividend payout ratio



Source: Prepared by FISCO from the Company's financial results

Disclaimer

■ For inquiry, please contact: ■
FISCO Ltd.
5-11-9 Minami Aoyama, Minato-ku, Tokyo, Japan 107-0062
Phone: 03-5774-2443 (Financial information Dept.)
Email: support@fisco.co.jp